BEHIND THE NUMBERS
Quality of Earnings Analysis

February 12, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

In this issue:

TransDigm Group Inc. (TDG) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reducing our earnings quality rating of TDG to a 2- (Weak)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

TDG reported adjusted EPS of $1.97 in the 1Q21, which missed the consensus by 4-cents. Our biggest issues with TDG are its debt level and that it adds back numerous recurring costs while enjoying some windfall sources of profit not in guidance. For example, in 1Q21, the company was guiding to an 18-22% tax rate. It came in at 5.5% for the quarter. Much of this is due to a tax shield on dividend equivalents recognized on stock option plans. However, that is a recurring item.

TDG's Covid costs are not going down either and are being used to pay costs associated with laying off workers. These are cash costs, look like restructuring to us as the company thinks rehiring will happen on a lagging basis as business recovers, and this is the bulk of the Covid cost. In 3Q20, TDG said Covid cost $24 million with only $3 related to cleaning, changing workplaces, etc. The last two quarters, Covid has been $22 million and $21 million with only $1 million in Covid cleaning protocols. In 1Q21, this added back about 27-cents to adjusted EPS for what does not look like Covid expenses.

TDG also added back $18 million in loss contract amortization in 1Q21 or about 24-cents in EPS vs. $11 million or 15-cents in EPS the prior year. Even their auditors highlighted this as a critical matter when TDG set it up because it requires significant management speculation and opinion on doing this transaction. We'll describe this more below.

Even TDG sees its Net Debt/EBITDA ratio reaching nearly 8x this year. What if air travel takes 2-3 more years to recover more fully? EBITDA is already overstating what actual cash flow is because of the high interest expense figure. Meanwhile, net debt of $16 billion may get close to 8x EBITDA of $2.0-$2.1 billion. The actual cash from operations is likely going under $1.0 billion as working capital rebuilds and capital spending is over $100 million already. There is still $4 billion in cash as part of the net debt picture here so TDG has liquidity available. TDG's stock gets a premium valuation because it makes frequent acquisitions to drive growth and pays high special dividends. It does not look like TDG can justify either at the moment.

What is weak?

- **Lower tax rates are a big help to recent results. The problem is the effective tax rate should increase next year.** The tax reform act limited the amount of interest expense that a company could use as a tax shield to 30% of the sum of EBITDA + Interest Income starting in 2019. The CARES act moved that percentage to 50% for years 2020 and 2021. Estimating this based on TDG's EBITDA of $2.3 billion, the amount of interest expense that is deductible went from $683 million to $1.1 billion in 2020. Since interest expense was $1.03 billion in 2020, it is fully tax-deductible. **The difference in the tax code added almost $73 million to earnings or $1.27 in EPS.** Likely that was not fully seen in 2020 because TDG's fiscal year started in October 2019. TDG is guiding to interest expense at essentially the same figure for 2021, which should again make it fully deductible (although EBITDA declining may keep a small part of interest out of the tax shield). In 2022, this formula not only reverts from 50% to 30% again – they will be using

EBIT not EBITDA to determine the 30% level. On 2020 figures, that would have only allowed TDG to shield $599 million of interest expense. Using the same EBITDA figures and interest expense under the three situations and making starting point $0.00, the CARES ACT is adding $1.27 to EPS, as that expires and the EBIT rule kicks in, income will fall $90 million below the starting point and EPS will fall $1.58. The swing from 2021 to 2022 would be $2.85.

- Loss Contract Reserves are an odd source of adjusted earnings. On some acquisitions, TDG identified contracts in place that were non-economic. So TDG compared the expected value of that contract to one signed under current market terms. The difference is set up as a loss contract reserve. That reserve is amortized through GAAP earnings. However, for adjusted EPS – TDG adds the amortization back to income as being non-cash. The result in our view is this gives adjusted results a picture that the contract is generating the profits of a different deal while GAAP still reflects the reality of the loss.

  In 1Q21, amortization of this account was $18 million up from $11 million in 1Q20. This added 24-cents to adjusted EPS of $1.97 vs. 15-cents in 1Q20 of $4.93. For all of fiscal 2020 – this was 50-cents of EPS.

- The Catch-22 for TDG is its operating model relies on making acquisitions or it posts organic growth rates of 2%-3% in most years. Also, one of the big ways it improves acquisitions is canceling volume discounts and/or boosting prices so it gets a bump in revenue early on. So a company that makes one deal can argue that some of the acquisition-related costs for legal issues, debt issues, combining software systems, consolidating real estate are one-time items. When a company makes 70 deals and touts that as the operating model – those items are recurring costs in our view and TDG is inflating adjusted EPS and EBITDA by adding them back in our opinion. TDG goes beyond that by adding back stock compensation as a huge part of this too and that occurs every quarter with or without acquisitions:

EPS Adjustments	1Q21	4Q20	3Q20	2Q20	1Q20
GAAP EPS	-$0.42	$1.76	-$0.09	$5.63	$0.83
Refinancing	$0.00	$0.02	$0.01	$0.05	$0.30
Acquisition Exp.	$0.05	$0.42	$0.24	$0.35	$0.24
COVID	$0.27	$0.39	$0.43	$0.00	$0.00
Stock Comp	$0.64	$0.57	$0.31	$0.16	$0.34
Dividend Equivalent	$1.24	$0.00	$0.00	$0.00	$3.22
Taxes	-$0.16	-$0.48	$0.58	-$0.95	-$0.22
Other	$0.32	$0.21	$0.06	-$0.14	$0.22
allocated Loss	$0.03	-	-	-	
Adj. EPS	$1.97	$2.89	$1.54	$5.10	$4.93

Refinancing happens continually. Acquisition integration recurs all the time. Covid has been including workforce payments with only minor amounts for what sound like Covid protocols. Stock compensation covers the expense that TDG is adding back, the dividend equivalent payments made annually on the stock compensation plans, and largely impact the taxes on the adjustments to deal with withholding taxes and compensation issues. If one only considers the stock compensation-related expenses as recurring items and part of the earnings model – that alone was 25% of adjusted EPS in 2020.

What to watch

- No impairments of Goodwill or Intangibles yet? This has surprised us because TDG is designed to be a serial acquirer of companies that sell airplane parts. Equity is -$3.7 billion, PP&E is only $777 million, working capital is only $1.0 billion, while Goodwill is $7.9 billion and Intangibles $2.6 billion. Despite many planes being idled – TDG has taken no impairment and reports that if they used a 100bp higher discount rate, it still would not see one. We have several areas of concern on this front:

    - The basic economic model for TDG is a plane model having a life of 20-30 years and how many are built and sold over that life and then operated for 10-20 years longer. They can estimate new parts and replacement parts doing that and value the goodwill.

    - We know from AirLease that airlines around the world have grounded their older planes and kept the new planes flying. This saves fuel and should save maintenance costs too. That should hurt TDG sales of replacement parts for a longer time.

- Some of the older planes may retire sooner than expected and that would mean a lower jet fleet overall for TDG to serve.

- What if many existing planes that are 15-18 years old, don't fly again but were expected to go on for 15-20 years? What if many larger planes are retired too – with the remaining ones flying long international routes 3x a week instead of 7x? What if Covid issues create a 3-year hole in the aviation industry where the fleets are not fully utilized and therefore not replacing parts at past rates? The plane is still aging and facing retirement questions.

- We do not think it would take much of these scenarios to drop future cash flow projections for several products in the TDG commercial portfolio by 20%-40% regardless of the discount rate. (The defense-related parts should not have this issue). Then remember the goodwill isn't being amortized, about one-third of other intangibles are trademarks and are not being amortized. The acquired technology is being amortized over 20-22 years. This isn't an issue that gets smaller as time goes forward since the balances are not declining much.

- **TDG is touted as a company that grows through acquisition and gives shareholders returns via growing EPS, growing EBITDA, and high dividends. We wonder if this model can work like that for the next several years:**

Cash Flow	2020	2019	2018	2017	2016
Adj. EBITDA	$2,278	$2,419	$1,877	$1,711	$1,495
Cash from Ops	$1,213	$1,016	$1,022	$789	$683
Cap Exp.	$105	$102	$73	$71	$44
Acquisitions	$0	$3,976	$668	$216	$1,399
Free Cash Flow	$1,108	-$3,062	$281	$502	-$760
Dividends	$1,928	$1,712	$56	$2,582	$3
Debt/EBITDA	6.7	6.4	5.8	6.5	6.8

- Even when they were running the acquisition model, the company was ratcheting up debt to pay for acquisitions and dividends.

- Cash flow was always much lower than EBITDA because of the huge interest cost on the growing debt.

- EBITDA will decline as pre-Covid quarters roll off and TDG already boosted debt with an acquisition in January. The company expects the debt multiple to approach 8x as it spent almost $1 billion of its cash after 1Q21.

- EBITDA was helped in 2020 by cutting costs amid falling revenues – TDG has said that those costs will return as business picks up even if it's on a lagging basis. Returning to $2.4-$2.5 billion for EBITDA may take years.

- Cash from operations was helped in 2020 by a positive $350 million y/y swing in working capital. As business returns, working capital should rebuild too and be a drain on cash flow.

- In 2021 and 2022, TDG will need to pay the deferred FICA taxes and in 2022, the tax law changes and should boost income taxes too – both should have negative impacts on cash flow.

- We think this shapes up as a company with cash from operations of under $1 billion, free cash flow of under $900 million before acquisitions, carrying debt of 7-8x EBITDA – how does it pay dividends of any material amount? And if it doesn't make deals, how does it justify a P/E of 29 based on a normal adjusted EPS of $20?

- While TDG was able to roll over some debt in 2021 at a lower rate, if business improves, do rates stay this low? A 50bp rise in interest rates is $100 million in higher expense. As the CARES act tax rules change in 11 months, we know TDG will lose more of its tax shield on interest so an increase in interest expense would come straight out of the cash from operations line.

- We think there will be more pressure to pay down debt sooner rather than later for TDG. The tax issues make it tougher for the EBITDA to carry as much debt as would rising interest rates.

Sealed Air (SEE) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We discontinue our SELL rating on SEE and continue earnings quality coverage with a rating of 2- (Weak) as part of our process of discontinuing our buy/sell ratings in favor of utilizing our quarterly Focus List to communicate top long ideas and sell recommendations. Note that SEE was featured as a sell recommendation in our Focus List issued in December and our outlook has not changed.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

Sealed Air's adjusted 4Q20 EPS of 89-cents beat forecasts by 10-cents. To say we are not impressed is an understatement. Through three quarters of 2020, SEE had an adjusted tax rate of 25.3% and was guiding to a 26% rate for the full year. That would have required a 4Q tax rate of 27.8%, which instead came in at 22.3%! The lower tax rate was 6.3-cents of the beat.

Also, after the 3Q, the CFO guided to lower volume growth for the Protective unit too:

> *"We were up [4.4%] in the third quarter. The guidance would imply a little bit less than that on a volume basis. And I think the thing we are a little bit cautious of there, even though the trends around e-commerce remain very robust."*

SEE gained some business in this area for the vaccine rollout and ended up reporting 7.4% 4Q growth. That is not forecast to recur and the outlook again calls for lower total organic growth of 3%-5% for 2021 already. We view this as an unexpected one-time event. We believe this added about 2-cents to EPS as well.

SEE also added back more recurring cash charges for consultants. This was 2-cents in EPS. The price/cost finally became a minor headwind per guidance in 4Q. It was only a negative $7 million against 10-straight quarters of it being a positive. This is supposed to even out over time – coming into 4Q, SEE was + $179 million on price/cost since 1Q18. Every $1 million SEE didn't lose here added 0.5 cents to EPS. It is worth remembering that SEE guided to -$70 million in headwind from this area for 1H20 and instead it remained positive in 2020. This was a huge source of EPS last year $0.46 for 1Q20 and 2Q20 and why we think the $7 million figure in 4Q20 may not be the worst SEE will report in this area.

What is weak?

- Price/Cost is when customers allow price increases by SEE to recover higher commodity costs. This has been a huge source of recent EPS growth at SEE. It is supposed to net out to zero over time. A quarter where price hikes taken exceed commodity inflation should be followed by a future quarter where commodity inflation exceeds pricing. The issue we have is SEE had 10-straight quarters where Price/Cost was a positive impact on earnings. It guided to this becoming a drag on earnings for several of those periods as well and that helped fuel EPS beating forecasts when results were actually a tailwind. 4Q20 finally saw a -$7 million impact from this and is saying that the 1Q and 2Q of 2021 should expect the same, and then contracts should allow it to recover some of this drag in 2H21. We believe this will be a larger drag on earnings going forward than many are forecasting. The amount of excess pricing SEE has taken over recent years far exceeds 4Q's $7 million.

- One move we have seen repeatedly by companies reporting weak-to-no growth is to continually reorganize the same assets into different divisions. This tends to make reported results almost impossible to decipher for a year as everything becomes apples-to-oranges comps for the same assets. We noted in the past that as part of the Reinvent SEE program – SEE pulled Mexico and Central American operations out of Latin America and moved them to North America. The remaining operations became a new division – South America in 1Q19. Now, only two years later, South America will be rolled into a new unit called the Americas and put it in with the rest of Latin America again as well as with North America. This is designed to "realign the organizational structure," which again is part of Reinvent SEE.

- SEE's reported organic growth has been helped significantly by hyper-inflationary pricing gains in South America which is less than 5% of sales. The pricing gains have been unrealistic to us at 15%-25% because SEE defines organic growth before the FX hit which at negative 22%-33% completely wipes out that organic growth. That has not prevented SEE from reporting 0.4% organic growth in 2020, but without South America, the result would have been -0.4%. In 2019, SEE reported 0.0% organic growth, but without South America it would have been -1.4%. It is important to realize that in 2020, South America's $39 million organic growth figure powered by inflationary pricing carried the whole company's growth. Yet, this South American growth was completely wiped out by a -$66 million FX hit. Since South America at less than 5% of sales was moving the company's reported growth rate, watch for it suddenly supercharging results for the new Americas division in 2021. FX will be a key adjustment here.

- The last 10-Q reported that IRS completed its examination of the $1.49 billion deduction on SEE's 2014 taxes and the IRS proposed to disallow the deduction. SEE will now seek to appeal through the IRS administrative appeal process. SEE noted that it may be resolved before the end of 2021. Debt/EBITDA is 3.1x at this point. This $525 million potential cash payment would add 0.5x to the ratio.

Supporting Detail

Price/Cost Rubber Band Is Still Stretched and the Reversal Could Be Significant

The company deals with many customers in the food-related, industrial packaging, and e-commerce areas. It notes that its contracts with customers are set up to allow it to pass through commodity inflation and also give back deflation. There are lagging timeframes between when prices are adjusted vs. when the new costs are realized.

The two key points to understand are 1) SEE cannot just push through price increases – the customers have to accept them based on the commodity cost data too and 2) the price increases tied to cost increases are supposed to net out to basically zero over time. Think of the cost changes being linear and moving all the time while the price changes move in a stair-step. Sometimes, pricing is ahead of costs and other times costs move ahead of pricing.

Going back to 2016 and 2017, SEE saw what should be expected, periods of minor tailwinds and headwinds to earnings as a result of this price/cost dynamic. Then in 2018, SEE suddenly gained 3 years of positives from this process:

Price/Cost	4Q	3Q	2Q	1Q
2020	-$7	$9	$19	$7
2019	$18	$24	$19	$22
2018	$15	$17	$29	-$4
2017	$2	-$10	-$9	-$5
2016	$9	$22	$9	$1

Historically, there are positive and negative periods. In 2016, there was a positive $41 million and $24 million unwound for nine months in 2017. In our view, from 2Q18 to 3Q20, this equation moved in SEE's favor by $179 million and should be expected to correct.

During much of this time, SEE guided to this reversing – it just didn't happen:

- In 2Q19 management said it benefited from lower input costs and expected less earnings contribution from Price/Cost in 3Q19 and 4Q19

- After 4Q19, management said to expect Price/Cost to be impacted by lower resin prices running through the contract formulas and said to expect -$70 million in price/cost in early 2020.

- After 4Q20, SEE said that investors should expect negative Price/Cost for the first half of 2021 but then contract formulas will help correct that for 2H.

Also, SEE has touted that some of the Price/Cost gains have come from its restructuring programs allowing it to source commodities more effectively. Some has also come from changing the content of the products – using less resin or using other materials instead for example. In our view, SEE will likely get to keep some of this Price/Cost. Let's say resin is $1/pound and the cost formula in the contract uses that price. If SEE is a better buyer and can purchase resin for $0.95/pound, it will likely get to keep the incremental nickel. However, if the contract is expecting SEE to use 5 tons of resin, but it changed its content and only used 4 tons – we think the cost formula will take that 20% reduction in resin usage into account.

Thus, we don't expect the full $179 million to reverse on SEE, but the headwinds could be much larger than the $7 million seen in 4Q20. Looking at guidance for the first half of 2020 calling for -$70 million in price/cost and SEE posting +$26 million instead – that's a 46-cent swing in EPS for two quarters. And if the company has already benefited from $179 million, a negative swing of $50-$70 million may be realistic.

South America's Hyperinflation Has Driven SEE's Organic Growth

We have pointed this out several times in the past as SEE defines organic growth as the combination of only price change and volume change. By this definition, investors should have shunned the FANG stocks in recent years and focused on where the big growth was – South America. Even a turnip farm in Argentina may have been reporting faster growth than Facebook. Even in the pandemic and travel closed to much of South America, SEE said that segment of operations grew at 16.7%. The year before, South America reported 26.6% growth and more importantly was the only segment to report growth at SEE.

2020	N.AM	EMEA	APAC	S. Am	Total	W/O S.Am
Price	-1.3%	0.2%	-0.1%	15.0%	0.0%	-0.8%
Volume	0.8%	-1.5%	1.6%	1.7%	0.4%	0.4%
Organic	-0.5%	-1.3%	1.5%	16.7%	**0.4%**	**-0.4%**
FX	-0.7%	0.1%	0.2%	-28.0%	-1.7%	-0.4%
Net Growth	-1.2%	-1.2%	1.7%	-11.3%	-1.3%	-0.8%

2019	N.AM	EMEA	APAC	S. Am	Total	W/O S.Am
Price	-0.3%	0.1%	-0.1%	21.5%	0.9%	-0.2%
Volume	-1.5%	-0.4%	-0.9%	5.1%	-0.9%	-1.2%
Organic	-1.8%	-0.3%	-1.0%	26.6%	**0.0%**	**-1.4%**
FX	-0.2%	-4.8%	-3.7%	-24.8%	-2.9%	-1.8%
Net Growth	-2.0%	-5.1%	-4.7%	1.9%	-2.9%	-3.2%

This simply doesn't pass the smell test. One of the items we looked at in prior reports on Sealed Air was the company just doesn't grow much. For a company devoted to supplying e-commerce and fresh protein – it just never reported much topline growth at all. Backing out South America from the results would cut reported organic growth in a material way: from 0.4% to -0.4% in 2020 and from 0.0% to -1.4% in 2019.

The hyperinflation giving SEE the strong pricing gains in South America are crushed by the FX hits there. This is a big reason why we do not think South America should be reported without FX for organic growth. Going forward, SEE is combining North America with South America for its reporting. That will likely make finding figures like these nearly impossible, especially since South America is less than 5% of total sales and North America is 59%. But we do believe investors should remember that leaving FX out of South American organic growth was enough of a factor to drive all the growth SEE reported in the last two years. We expect to see growth suddenly explode upward on pricing for the new America's division in 2021. We believe that will be a mirage just as South America's hyperinflation was the last two years.

Ares Capital Corp. (ARCC) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We discontinue our BUY rating on ARCC and initiate earnings quality coverage with a 5- (Strong) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations. Note that we do see reduced upside for ARCC with the company selling above book value and the Q4 performance likely difficult to duplicate in the near-term.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

ARCC had a blow-out 4Q with core EPS coming in at 54-cents vs. the dividend of 40-cents. The problems in 2Q and in 3Q were reduced gross fundings of $867 million and $706 million. That in turn lowered capital structuring fees to only $16 and $12 million. Net investment income and capital fees only produced 39-cents in core EPS in those quarters. That rebounded strongly for 4Q results:

Core	4Q20	3Q20	2Q20	1Q20	4Q19
Gross Commitments	$3,868	$706	$867	$1,272	$1,608
Invest. Income	$136	$154	$151	$148	$152
Inv. Core EPS	$0.32	$0.36	$0.36	$0.34	$0.35
Capital fees	$93	$12	$16	$28	$38
Cap fees Core EPS	$0.22	$0.03	$0.03	$0.07	$0.09
Total Core EPS	$0.54	$0.39	$0.39	$0.41	$0.43

- 4Q20 saw a higher level of incentive fees liked tied to the huge commitment level and higher fees that we estimate cut core EPS by about 3-cents.

So a regular quarter is essentially 35-36 cents in investment income net of expenses and 9-10 cents in capital fees for a core EPS of about 45-cents against a dividend of 40-cents. Even ARCC admits it is unlikely to do $3.9 billion in new investments in a quarter going forward. That's the first reason we are moving ARCC to a Neutral.

The second reason for moving to a Neutral rating is the company is trading above book value. That is rare for a BDC and it can only issue stock when the stock is above book. Book ended at $17 and ARCC announced a secondary for 13.5-15.5 million shares (about a 3.2-3.7% increase in the share count) after the 4Q earnings call at over $18. As we will discuss below – this offering looks opportunistic for future growth, but it probably reduces the potential for much capital appreciation in the near future for the stock and investors will need to be satisfied with the nearly 9% cash yield, which we consider solid.

What is strong?

- Investors should remember that ARCC bought back $100 million in stock at the start of Covid for under $12 per share. That was about a 25% discount to impaired book value at the time. That also reduced total dividends by about $13 million per year during Covid. It is now issuing about 3-4% new shares at $18 and a 10% premium to book that already rose 9% off the low. When many other companies refuse to buy when shares are cheap and cannot wait to buy when their shares are expensive – it is nice to see a company follow basic investment philosophy of buy cheap and sell dear.

- Interest income may have some drivers to boost income going forward. First, not all the new deals were in place for the whole quarter. Thus, interest income rose 5% from 3Q but the portfolio rose by 8%. If both had grown (along with interest expense) by the 8% figure, ARCC would have realized another 2-cents in EPS in 4Q. The average yield is also rising about 10bp. There are about 84% of investments listed as floating rate and 84% of those have Libor floors of 1.1% so rates can rise and likely not fall much at this point.

- ARCC is still set up to benefit from rising interest rates. When rates are more normalized – a 10bp bump in yield is worth about 1-cent in core EPS per quarter. At the same time, ARCC has locked in some more financing on fixed-rate notes at 2.15% so funding costs should not rise as quickly as investment yields.

- There is still about $1.07 per share in spill-over income. This is earned income that ARCC needs to pay out over time and views it as a way to support the 40-cent dividend in volatile or weak periods for results. It is also possible, ARCC could declare more special dividends as it did in 2019 adding 2-cents per quarter to the regular payout.

- Stats on the portfolio look strong. Non-accruals peaked in 3Q at 5.1% and are now 3.3% of the portfolio. These investments have already been marked down to 58% of cost.

Average EBITDA for the companies rose 5% y/y in 4Q. Many of the companies being funded now had lesser Covid issues and are still growing. Many are long-time customers who ARCC is familiar with. It has seen stronger covenants and terms and it is dealing with larger and more established companies overall – the average EBITDA is $156 million up from $99 million two years ago. The Loan-to-Value ratio is about 50%. 4Q saw ARCC collect 99% of scheduled interest too. It is now known that private equity investors in many of these deals were willing to support the companies during Covid too.

What is weak?

- Much of what we see at ARCC at this point for weak points are more of an issue of they will have a tough time duplicating the level of business in 4Q. Even the CFO noted that there were deals being worked on through 2020 that finally closed in 4Q along with other deals that may have happened in 1Q21 that were pulled into 4Q. He highlighted that the backlog is about equal to last February pre-Covid, but that's not enough to reproduce the 4Q results.

- Debt to Equity ended the quarter at 1.17x net of cash. ARCC wants to remain between 1.0-1.25x, so there is less room to grow that ratio at first glance and expanding investments paying 9% with 2% debt is how income grows for ARCC. We would note that the company's stock offering should raise $240-$270 million which would add to equity and lower net debt and should push the ratio below 1.1x.

- Issuing shares has some downside in that it will add $25 million to the total dividend payout per year at 40-cents per quarter. That could have been used to grow the current dividend by 1.5 cents per existing share. Plus, the cost of equity capital is about 9% for ARCC vs. 2% for debt. That is expensive if it is not put to work quickly. From the comments on the call, ARCC's team is excited about the outlook to grow, but 1Q volumes should be much lower and it may take longer to put this new money to work and boost the debt/equity ratio again. The higher share count would have cut about 2-cents off core EPS in the quarter assuming it is not employed quickly. That is not a deal-breaker for the dividend by any means – but it does point to perhaps less capital appreciation potential at this point.

- Ultimately, capital appreciation on ARCC may require the new equity be put to work and at a debt/equity ratio closer to 1.2x. That would drive core EPS higher and perhaps lead to dividend growth.

Air Products and Chemicals, Inc. (APD) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of 4- (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

APD reported EPS from continuing operations of $2.12 in the 12/20 quarter which was 8 cps short of consensus estimates. Management noted on the call that the quarter contained 10-15 cps in incremental COVID-related expenses along with higher maintenance expenses timed around unscheduled plant downtime. To its credit, the company also continues to invest in R&D and business development during the pandemic.

However, investor concern seemed to be mostly focused on the lack of visibility into the reopening of the Lu'An facility. APD participates in a non-consolidated JV with Lu'An to operate a clean energy facility on Lu'An's site in China. The company reached an agreement to reduce its fee received from the JV during the duration of the shutdown in return for extending the contract term. Management indicated that the extension improves the company's total return on the project and it expects the plant to be back online in 2021. Nevertheless, the lower revenue hit the quarter and management has not released much in the way of clarification as to the reason for the shutdown or the exact time frame on reopening. This was a focus of conversation in the Q&A on the conference call with some analysts seemingly concerned that the Lu'An interruption could be heralding problems with other JV projects in China. While this seems like an overreaction to us, this could be an overhang on the stock for a while.

Overall, we continue to view APD's earnings to be of solid quality. However, we will refrain from raising our rating at this time due to non-operational benefits to the most recent quarter below without which the earning miss would have been worse.

What is strong?

- As noted above, despite APD's complex business model which regularly involves huge capital investments to build and operate facilities on customers' sites under long-term contracts, the company makes relatively few non-GAAP adjustments to earnings.

- We also applaud the company's regular itemized presentation in its Management's Discussion and Analysis sections of its SEC filings showing the sources of EPS growth in each period which makes it easy for investors to see when items such as lower tax rates are boosting growth.

What is weak?

- Other income jumped by $10.2 million or 4 cps due to the settlement of a supply contract which was an unexpected benefit to EPS in the period.

- The effective tax rate fell to 19.3% from 19.8% which added about 1 cps to EPS. The company continues to anticipate a full fiscal year 2021 tax rate of 20-21%, so this benefit was not likely accounted for in analysts' models.

- Pension cost swung from an expense of $400,000 to a $9.5 million income due to lower interest cost and lower amortization of actuarial loss resulting in a 3.5 cps boost to EPS growth. Most of this impact is seen in "other non-operating income."

- Lower share-based compensation expenses added about 1.5 cps to EPS in the quarter.

- Equity affiliate income rose by 4 cps in the quarter driven by 19% growth in profits from investments in affiliates accounted for under the equity method. Equity income is always a material amount, regularly accounting for approximately 10% of total company pretax profits. In the 12/20 quarter, the company attributed the increase to growth in affiliates in India, Italy, Mexico, and Saudi Arabia. While this is the appropriate way to account for equity joint ventures in which the company has less than 50% ownership, the lack of visibility into the results makes the growth lower quality.

What to watch

- We note that capitalized contract fulfillment costs have been rising faster than the associated equipment revenues. This would ordinarily be a concern if revenue under the contracts was recognized upfront or ratably. However, equipment revenue is mostly recognized as costs are incurred, and the increase in capitalized costs appears to correspond to a buildup in deferral in the recognition of revenue associated with the projects.

Supporting Detail

Jump in Contract Fulfillment Costs

Approximately 4-6% of company revenue is generated by the sale of cryogenic and gas processing equipment to customers. There is considerable installation time and cost involved with these equipment contracts. The company capitalizes certain costs to fulfill these contracts as described in the 10-K:

> *“Contract fulfillment costs primarily include deferred costs related to sale of equipment projects that cannot be inventoried and for which we expect to recognize revenue upon transfer of control at project completion or costs related to fulfilling a specific anticipated contract.”*

Note that these costs are separate from contract acquisition costs such as commissions which the company indicates are not material.

The following table shows the calculation of contracts fulfillment days of sales based on the company’s sales of equipment reported in its revenue breakouts:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Sale of Equipment	$161.7	$189.0	$133.7	$133.1
Contract Fulfillment Costs	$140.9	$109.9	$100.7	$84.8
Contract Fulfillment Costs Days of Sales	80.2	53.5	68.5	58.0

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sale of Equipment	$127.0	$124.6	$94.7	$76.2
Contract Fulfillment Costs	$86.1	$64.5	$66.4	$65.9
Contract Fulfillment Costs Days of Sales	62.4	47.6	63.8	77.8

A disproportionate increase in capitalized costs relative to the growth in related revenue is always a concern as it could indicate that the company is becoming more aggressive in capitalizing expenses to the benefit of profits. However, we are not especially alarmed by the increase in the days of sales figure as the company's recognition of equipment revenue is tied to incurring expenses. Consider the following discussion from the 9/20 10-K on the recognition of equipment revenue:

> *"Our sale of equipment contracts are generally comprised of a single performance obligation as the individual promised goods or services contained within the contracts are integrated with or dependent upon other goods or services in the contract for a single output to the customer. Revenue from our sale of equipment contracts is generally recognized over time as we have an enforceable right to payment for performance completed to date and our performance under the contract terms does not create an asset with alternative use.* ***We recognize these contracts using a cost incurred input method by which costs incurred to date relative to total estimated costs at completion are used to measure progress toward satisfying performance obligations****."*

Unrecognized revenue remains deferred until costs are incurred. The following table shows deferred revenue for the last eight quarters.

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Total Contract Liabilities (Deferred Revenue)	$492.8	$371.7	$368.9	$335.3

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Total Contract Liabilities (Deferred Revenue)	$338.2	$296.6	$233.9	$244.4

Consider the following description of contract liabilities from the 10-K:

> *"Contract liabilities include advance payments or right to consideration prior to performance under the contract. Contract liabilities are recognized as revenue when or as we perform under the contract. The increase in our contract liabilities – current balance primarily relates to new sale of equipment projects as balances associated with our sale of gas contracts are generally related to fixed charges and are relatively consistent period over period."*

Note that since contract liabilities do contain balances associated with gas contract revenue, we are reluctant to relate them directly to equipment revenue as we did with contract fulfillment costs in the first table. However, the company does indicate the increase in contract liabilities is primarily tied to rising equipment sales. Also, the increase in contract liabilities does correspond to the increase in capitalized fulfillment costs. We are therefore not concerned by the rising capitalized costs as in this case, they appear to be essentially tied to a delay in revenue recognition.

This trend should be monitored going forward for any sudden disconnect between the growth in capitalized fulfillment costs and the growth in deferred revenue.

Citrix Systems (CTXS) Earnings Quality Update
12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of 4- (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

CTXS reported EPS of $1.46 in the 12/20 quarter which was 12 cps ahead of targets. Management also gave full-year 2021 guidance ahead of the consensus. The market liked the quarter as growth in SaaS analyzed recurring revenue signed during the quarter accelerated after a deceleration in the 9/20 period.

We do not have any major concerns with the company's earnings quality and revenue recognition metrics seem to support management's story. Still, we were unable to upgrade our current earnings quality rating due to some concern over a jump in capitalized contract acquisition costs.

What is strong?

- CTXS has now discontinued selling new perpetual *Workspace* licenses. It has also transitioned away from the short-term license deals it implemented in the first half of 2020 to help new customers set up their remote access capabilities at the onset of the pandemic. Management stated in the call that it has already seen one large customer convert its short-term license to a longer-term cloud-based subscription deal. Signs are initially positive as SaaS ARR was up 39%, a reacceleration from the previous quarter's 36%. In another positive sign, subscription bookings as a percentage of the total increased to 85% in the 12/20 quarter from 69% a year ago.

- Deferred revenue days of sales recognized over time rose by 11 days, continuing the positive trend as perpetual license deals continue to decline in the mix. This is more positive evidence of the company successfully transitioning to the SaaS subscription model.

What is weak?

- There was a 22% sequential increase ($36 million) in capitalized contract acquisition costs in the 12/20 quarter which the company indirectly attributed to higher subscription sales. We know that subscription revenues are growing, but the size of the jump relative to previous quarters appears unusual. For reference, a $10 million increase in capitalized costs would add about 6 cps to EPS.

- CTXS's buyback has been reducing the share count by more than 5% YOY for several quarters. Management indicated that it will take it a couple of years to pay down debt to target levels after the Wrike acquisition. During that time, the buyback will presumably be scaled down which will reduce the EPS tailwind from declining share count.

- Accounts receivable days of sales rose by 15 days versus the year-ago quarter following a 14-day YOY increase in the 9/20 quarter. As noted above, the uptick in longer-term subscription deals which resulted in the rising deferred revenue is likely increasing the size of the average invoice. This could explain the increase in receivables relative to the increase in revenue recognized in this quarter. We will continue to monitor this trend but are still not overly concerned.

- On the subject of receivables, we note that the allowance for doubtful accounts rose to 3% of gross receivables, up from 2.7% in the 9/20 quarter and 1.3% in the 12/19 quarter. We would expect the reserve percentage to be above last year's level given the pandemic, but the sequential increase is noteworthy as it could be an indication of collection issues and should be monitored in the first quarter.

What to watch

- CTXS announced during the quarter that it will acquire Wrike, a leading provider of SaaS collaborative work solutions for $2.25 billion in cash. CTXS will pay for the deal with cash on hand plus debt financing and the deal is expected to close in the first half of the year.

Wrike had annualized recurring revenue of only $140 million. CTXS stated that it expects the transaction to be neutral to non-GAAP earnings for 2022 and accretive thereafter. We assume that the company will add back amortization of intangibles to non-GAAP along with incremental stock-based compensation related to the deal. Management statements seemed to imply that purchase accounting and integration charges would dilute non-GAAP EPS although we will very surprised if the company does not end up adding those costs back to non-GAAP results. This leaves interest on the debt as the only major dilutive impact we can see. The fact it will take a year to reach accretion on a non-GAAP level indicates how much the deal depends on cross-selling to work.

Supporting Detail

Increase in Capitalized Contract Acquisition Costs

Like most software companies and as allowed under ASC 606, the company capitalizes the costs to obtain contracts that are considered incremental and amortizes them over the expect benefit period. These costs include such items as sales commissions. The following table shows capitalized contract costs, the amortization of the balances, and amortization expense as a percentage of the average outstanding balance during the quarter:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Capitalized Contract Acq Costs	$196.2	$160.3	$150.0	$142.2	$131.4	$114.7
Amortization of Contract Costs	$15.9	$14.7	$13.8	$13.1	$11.8	$11.4
% of Avg. Contract Cost Balances	8.9%	9.5%	9.4%	9.6%	9.6%	10.1%

We note the sharp sequential increase in capitalized balances in the 12/20 quarter. The company stated in the liquidity section of the 10-K that operating cash flow for the full year was pressured by the “increase in capitalized commissions from higher subscription sales.” We know that there was an uptick in subscription revenue in the quarter, but the 22% sequential increase in the balance still looks unusual. For reference, a $10 million increase in expenses capitalized rather than expensed would boost EPS by about 6 cps.

Another item that stands out is the decline in amortization expense as a percentage of the average capitalized balance. This could result from an increase in the duration of new contracts compared to those signed in past quarters. This is not particularly material as the sequential decline in the amortization percentage would have added less than a penny per share to EPS in the period.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.